A foot in the door

While the big growth in pension scheme deficits took place between 2000 and 2003, it is only recently that the consequences have started to emerge. Deficits have been a stumbling block in a number of high-profile corporate deals, and in some cases special dividends or share buybacks have had to be abandoned.

As a result, some have concluded that companies with pension deficits are both unsaleable and cannot return capital to shareholders. This is obviously untrue – merger and acquisition activity remains at a high level even for companies managing large pension deficits, as does capital return activity. But there is no doubt that new legislation gives trustees greater negotiating rights, and the new Pensions Regulator, with its keen eye for pension security, is ensuring that pensioners' rights are being exercised.

FINANCIAL SIGNIFICANCE OF PENSION DEFICITS The FTSE 350 companies had an estimated aggregate deficit of £93bn (measured under the accounting standard IAS 19 *Employee Benefits*) at 31 December 2005[1]. This represented a 20% increase over the year, and market conditions pushed it higher in early 2006. The deficit is equivalent to around 5% of market capitalisation on average. But the average hides a big range – 5% of companies have deficits in excess of 30% of market capitalisation, which typically means the total fund (as opposed to the deficit) is larger than the operating business. It may also mean that pension scheme members – employees and ex-employees – are the biggest suppliers of debt finance in those cases.

Settling the IAS 19 deficit does not allow a company to walk away from its pension scheme. To detach itself from its pension liabilities, a company has to fund them on the terms set by insurance companies. On this basis the deficit is usually at least two or three times higher.

PENSIONERS AS SUPPLIERS OF UNSECURED DEBT For years the position of a pension scheme in the corporate capital structure was legally fudged. There was a commitment to specified payments over a period of time (as with a bond) but collateral requirements were limited and the bond could be redeemed on off-market terms at the company's option.

This has now changed. The only way out of the full pension commitment is bankruptcy or settlement via an insurance company. And under the new statutory funding objective (SFO) regime being phased in, pension scheme trustees are required to ensure their commitments are covered by collateral – in other words, scheme assets. The amount of collateral sought needs to be calculated "prudently".

Consequently, trustees suddenly have a series of blocking powers to corporate activity, when previously they were more or less a passive source of finance.

DEALS, CAPITAL RETURN AND THE PENSIONS REGULATOR These issues first came to the fore when the Pensions Regulator opened for business in April 2005, tasked with ensuring corporate activity could not be used as cover to escape benefit commitments. Its *modus operandi* is to remind trustees of their powers and its expectation is that they will use them. At the same time, it threatens company directors who try to dodge their commitments with personal liability for the deficit and therefore financial ruin.

The breadth of the regulator's powers has companies queuing at its door for 'pre-clearance' of prescribed activities to avoid subsequent sanction. Such activities include takeovers and mergers involving extra gearing and substantial returns of capital, such as special dividends and buyback programmes. The price of approval is often an increase in scheme contributions, frequently on the basis of a large lump sum, and funding of the remaining deficit over three to seven years.

This situation is hitting private equity deals and other debt-financed takeovers in particular. This is uncomfortable for many vendors, who may not achieve the prices they could demand when the pension scheme was a soft touch. So for a period this is seen as a showstopper, although over time we can expect price expectations to respond and the markets to move on.

THE SECOND WAVE: SFO NEGOTIATIONS The regulator has focused on corporate deals, with most capital return activity exempt as long as it is done out of distributable reserves. So while we have seen deals blocked, there has been less impact on dividends.

But this may change as trustees start to use their powers under the SFO regime. Actuarial valuations are often carried out on a three-year

TIM KEOGH WONDERS WHETHER PENSION TRUSTEES ARE FORCING THEIR WAY INTO THE BOARDROOM.

Executive summary

- New legislation is giving trustees greater negotiating rights and regulation is ensuring these rights are being exercised.
- Trustees now have the powers to block corporate activity, when previously they were a passive source of finance.
- Trustees may seek removal of a significant part of the deficit in order to cede control over corporate activity and returns to shareholders.

cycle, and all valuations after September 2005 are affected.

The increasing influence of trustees is important. They now have considerable power in seeking higher pension contributions, better benefit security or a more conservative investment strategy. While some powers are new, others already existed but trustees did not always feel empowered to use them. They are now increasingly likely to exercise that power – for example, by threatening to change the investment strategy in the absence of a satisfactory agreement, with adverse implications for contributions.

Trustees have to assess an employer's ability to fund a scheme in order to decide what is "prudent", which has created a new market in suitable due diligence work. Copying banking practice, trustees will look for protection from any corporate activity which may increase the risk to them, and may see dividends and buybacks in this light regardless of the niceties of the distributable reserve calculation.

While the natural corporate reaction will be to resist, a more collaborative response may follow if the alternative is a much higher cash payment up front. It may become common for the return of cash to shareholders to be accompanied by deficit reduction, just as paying down other debt is often preferred to the cash return. Where there is reasonable cashflow, trustee pressure will be focused on dividend increases and special payments rather than maintenance of existing levels.

The government has bent over backwards to avoid reducing prudence to a formula, for fear of being accused of introducing a new minimum funding requirement. The Pensions Regulator is similarly hesitant to set specific standards, but has embarked on a process of broad hints as to what it hopes to see achieved. For many companies a decision to fund at less than full IAS 19 levels, or to achieve this over longer than 10 years, is likely to require extra justification. This is a more stringent target than most companies have contemplated so far, implying significant contribution increases.

DOES IT MAKE SENSE TO PAY OFF THE DEFICIT ANYWAY? The price of getting back control over corporate activity and returns to shareholders may be the removal of a significant part of the deficit, either by using available cash resources or refinancing through other borrowing.

For a creditworthy company this may be no bad thing. There is a tax benefit from borrowing net and investing gross within the pension fund. Credit and equity analysts will not generally see this as an increase in debt, given that the deficit is usually counted as debt for rating purposes. There may be a parent company with access to cheap finance.

In any case, from April this year the government's pensions lifeboat – the pension protection fund (PPF) – is charging a levy to schemes in proportion to their deficit and creditworthiness. Some of these levies will be very large, so if the deficit is paid off much of the credit spread incurred in borrowing may be offset by reduced levy payments. The levy calculation is normally based on the D&B failure score for the sponsoring employer, and the PPF incentive can be even stronger if the company's structure is such that this measure reflects poorly on the group's overall financial strength.

This thinking is gaining ground – in a recent survey[2] of large company finance leaders 18% of respondents said they had increased borrowing to fund pension contributions. Often, this is not directly visible – borrowing requirements are determined by overall business needs, and it is rare for there to be a specific cash-raising exercise purely for pension reasons. But a number of substantial lump sum cash injections have been announced in recent months, often made by strong companies with manageable deficits which nevertheless wish to reduce the hassle associated with running a deficit.

THE BOTTOM LINE There is a small minority of companies for which the pension scheme has become too onerous to support. In these cases, the businesses are economically bankrupt if not technically so. This blocks payment of dividends pending the inevitable restructuring or sale, and the pension trustees and Pensions Regulator will be key players. As with any distress situation, there is a delicate and possibly painful balance to be struck in salvaging underlying business value and keeping jobs. We have already seen a few of these cases where a deal with the Pensions Regulator has been announced, but they are the exceptions.

For everyone else, the new environment is all about price when it comes to selling the business, and the size of the lump sum to keep the trustees on side when it comes to special dividends. The simplest way of keeping trustees on side may be to fund the deficit and borrow elsewhere. Alternatively this may be a natural and value-enhancing use for spare cash, or the strength of the parent company may be brought to bear.

If these solutions are impractical or undesirable, expect the pension trustees to spend more time in your boardroom.

1. Mercer Retirement Financial Management Statistics, January 2006
2. Mercer survey of Pension Financial Risk, September 2005

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